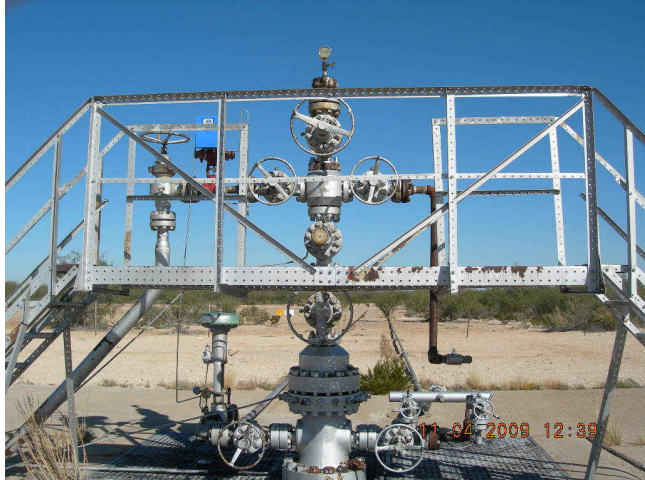


OIL & GAS ROYALTY AUDIT GENERAL INFORMATION

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TEXAS GENERAL LAND OFFICE
JERRY PATTERSON, COMMISSIONER



OIL & GAS ROYALTY AUDIT – GENERAL INFORMATION

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LEGAL AND STATUTORY AUTHORITIES

AUDIT AUTHORITY

Pursuant to § 52.135 of the Texas Natural Resources Code, the Texas General Land Office (GLO) has been delegated state audit authority. As such, the GLO has the right to inspect and examine books, accounts, reports, and other records relating to the payment of royalties, in-kind volume deliveries, and/or other consideration due to the State.

Pursuant to a delegation of audit authority from the United States Department of the Interior (Federal Oil and Gas Royalty Management Act of 1982, § 205, and the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996), the Texas General Land Office has also been granted the right to conduct audits of federal lands in which the state of Texas shares in the resources.

STATUTE OF LIMITATIONS

State royalties are not subject to statute of limitations due to the State of Texas' Sovereign Immunity.

All Federal leases have a seven-year statute of limitations in accordance with the Federal Oil and Gas Royalty Management Act of 1982. This Act states the following in § 307: "Except in the case of fraud, any action to recover penalties under this Act shall be barred unless the action is commenced within 6 years after the date of the act or omission which is the basis for the action."

CONFIDENTIALITY

Pursuant to § 52.140 of the Texas Natural Resources Code, all information secured, derived, or obtained during the course of an inspection or examination of books, accounts, reports, or other records is confidential and may not be used publicly, opened for public inspection, or disclosed except as outlined below.

This confidentiality does not apply in the following situations:

- Information set forth in a lien filed under Chapter 52 of the Texas Natural Resources Code;
- Information to enforce any provisions of Chapter 52 of the Texas Natural Resources Code or in judicial or administrative proceedings in which the state is a party;
- Information concerning the amount of royalty assessed as a result of information made confidential by this section to the lessee or its successor;
- Information published as statistics which do not identify particular audits;
- Information which is otherwise available to the public; or
- Information concerning the amount of royalty assessed as a result of an audit.

The GLO will inform the auditee if an Open Record Request is made on any documents or information provided pursuant to an audit request.

RIGHT TO FORFEIT A LEASE

The GLO's assessment and collection of penalty does not affect its right to forfeit a lease. Title 31 of the Texas Administrative Code § 9.51 provides as follows:

"The state's power to forfeit a lease is not affected by the assessment or payment of any delinquency, penalty, or interest as provided in this subsection. Specifically, the lessee's failure to pay royalties and other sums of money within 30 days of the due date or the failure to file reports completed in the form

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and manner prescribed by this section shall subject a lease to forfeiture under § 9.95 of this title (relating to Forfeiture)."

LEGAL AND STATUTORY REQUIREMENTS

ROYALTY PAYMENT REQUIREMENTS

Pursuant to § 52.131 of the Texas Natural Resources Code regarding royalty payments, the lessee has the responsibility for paying royalties or having royalties paid by the date provided for payment. Lessees and companies paying on their behalf, are encourage to review the lease agreements, consult with their Land/Legal Department, and/or GLO's Audit/Legal Department to obtain a better understanding on how to calculate State's Oil and Gas Royalties.

SUCCESSOR LIABILITY REQUIREMENTS

Pursuant to § 52.026 of the Texas Natural Resources Code on lease transfer, a lessee of an area under this subchapter may transfer the lease at any time. The liability of the transferor to properly discharge its obligations under the lease shall pass to the transferee upon prior written consent of the Commissioner of the General Land Office. Every lease transferee shall succeed to all rights and be subject to all obligations, liabilities, and penalties owed to the state by the original lessee or any prior transferee of the lease, including any liabilities to the state for unpaid royalties.

RECORDS REQUIREMENTS

Pursuant to § 52.135 of the Texas Natural Resources Code regarding inspection and examination, the books and accounts, receipts, and discharges of all lines, tanks, pools, and meters and all contracts and other records relating to the production, transportation, sale, and marketing of the oil and gas are subject at any time to inspection and examination.

Examples of the records that are subject to examination include, but are not limited to, the following:

- Meter Statements,
- Crude Oil Run Tickets,
- Purchase Statements and Remittance Advices,
- Lease, Well, and Plant Schematics,
- Plant Allocation and Settlement Statements,
- Gas Measurement Charts,
- Chromatographic Information/Natural Gas Liquid Product Analysis,
- Accounting and System Processing Procedures and Flow Charts,
- Contracts, Agreements, and Amendments for Oil and Gas Purchases, Marketing, Transporting, Gathering, etc.

RECORDS RETENTION REQUIREMENTS

Lease operators, lessees, purchasers, and other responsible parties have ongoing obligations to retain accurate and complete records necessary to demonstrate that their oil and gas royalty payments and/or in-kind volume deliveries comply with lease terms, regulations, and statutes. It is therefore the responsibility of the above noted parties to maintain and preserve these documents.

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ROYALTY AUDIT PROCESS

AUDIT NOTIFICATION LETTER

The GLO will inform the entity being audited (auditee), by virtue of an Audit Notification Letter, of a pending audit. The Audit Notification Letter describes the scope of the audit and requests certain information and materials.

REQUEST FOR DOCUMENTS

After the Audit Notification Letter, the GLO will request certain documents or records (see Records Requirements above) be made available by a specified due date. This Request provides the following specific audit information to the auditee:

- The individual leases being audited,
- The time period covered by the audit, and
- The particular types of documents/records being requested for:
 - 1) Each lease in the audit,
 - 2) The time period for which the various documents are needed for each lease.
- Other additional information, documents, and/or records may be included in this Request or may be requested at a later date during the audit.

AUDIT OPENING CONFERENCE AND FIELDWORK

The GLO will then contact the auditee to schedule an Opening Conference at the auditee's office. Auditee representatives at the Opening Conference should include senior management and other key personnel responsible for the oil and gas production, sales, reporting, and payment of royalties on State owned lands. Inclusion of management for production operations and the marketing of production on State lands could also be beneficial. The audit fieldwork usually begins with the Opening Conference and a portion may be done at the auditee's office. Fieldwork consists of interviews with key personnel as well as gathering audit documentation and analyzing and evaluating that information.

AUDIT CLOSING CONFERENCE AND PRELIMINARY AUDIT REPORT

Upon the audit's completion, the GLO will schedule a Closing Conference to present the auditee with a Preliminary Audit Report and discuss the findings. If, it is determined additional royalties are due, the Preliminary Audit Report will include schedules that specify the amount of Royalty Due and the reasons for such determination. The auditee then has thirty (30) days to contest any of the issues in the report with an audit response and additional documentation. The GLO will consider the audit response and revise the Preliminary Audit Report as necessary. The auditee will then have fourteen (14) days to respond.

FINAL AUDIT REPORT AND AUDIT BILLING NOTICE

Once the issue(s) in the Preliminary Audit Report has been resolved or determined to be disagreed, a Final Audit Report and Audit Billing Notice (ABN) will be issued. The ABN will specify the additional royalty due, along with any applicable penalty and interest, and the reasons for the determination. In accordance with the Texas Natural Resources Code § 52.135(c) the auditee has 30 days from the date of the receipt of the Final Audit Report and ABN to pay the audit deficiency assessment or to request a hearing before the commissioner or his representative for redetermination of such assessment. The lessee may pay the additional royalty due to stop the accrual of penalty and interest.

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ROYALTY AUDIT PROCESS (CONTINUED)

RECOURSE ON UNPAID AUDIT BILLING NOTICES

The GLO has the following recourse for outstanding Audit Billing Notices:

1. Warrant Holds on debtor
2. Liens and Security Interests
3. Lease Forfeiture

The following provides a short explanation and the legal cite for these remedies:

- Potential Refunds and/or Payments subject to Warrant Hold - The Texas Government Code § 403.055 authorizes the Texas Comptroller of Public Accounts, upon proper notification from the GLO, to withhold payments due from the State to an entity with unpaid Audit Billing Notices. The amount of the Audit Billing Notice outstanding may also be deducted from state payment amounts per the Texas Government Code § 403.0551.
- Statutory First Lien, Express Contractual Lien and Security Interest - The Texas Natural Resources Code § 52.136 grants the state a statutory first lien on all oil and gas produced on any lease area to secure payment of unpaid royalty and other amounts due. Acceptance of a lease, also secures the payment of royalties and other amounts due as it grants to the state an express contractual lien on and security interest in all oil and gas in and extracted from the lease, all proceeds from the sale of the oil and gas, and all fixtures on and improvements to the lease used to produce or process oil and gas. These statutory and contractual liens and security interests may be foreclosed with or without court proceedings in the manner provided in the Texas Business & Commerce Code Chapter 9.
- Forfeiture of Rights - In accordance with the Texas Natural Resources Code § 52.176, if any person, firm, or corporation operating under this law shall fail or refuse to make the payment of any sum within 30 days after it becomes due, the rights acquired under the permit or lease shall be subject to forfeiture by the commissioner, and he shall forfeit same when sufficiently informed of the facts which authorize a forfeiture, and the oil and gas shall be subject to sale in the manner provided for the sale of other forfeited rights hereunder, except that the owner of the soil shall not thereby forfeit his interest in the oil and gas. Such forfeiture may be set aside and all rights theretofore existing shall be reinstated at any time before the rights of another intervene, upon satisfactory evidence of future compliance with the provisions of this statute.

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REVIEWS OTHER THAN AUDITS

The GLO routinely conducts inspections and examinations that are authorized under the same statute as the audits, Texas Natural Resources Code § 52.135. These examinations do not result in an Audit Billing Notice and are not subject to the *Limitations on Audit Assessments* § 52.139 of the Texas Natural Resources Code. The three types of examinations are discussed below.

LIMITED REVIEW

In addition to conducting Royalty Audits, the GLO also conducts *Limited Reviews* on State Leases that are limited in scope and usually concern a single issue. If additional revenue is detected, the GLO will issue a Limited Review Notice.

LEASE VOLUME RECONCILIATION

The GLO performs *Lease Volume Reconciliations* on state owned leases. GLO compares well production and sales volume data reported on the GLO oil and gas production reports to the volumes reported on the Railroad Commission PR Reports for the same lease and period. If under reported volumes are detected, the GLO will submit to the reporting company a Reconciliation Billing for royalty due on those volumes.

DUE VS. PAID LEASE RECONCILIATION

The GLO also conducts *Due vs. Paid Lease Reconciliations*, comparing royalty due amounts (from GLO oil and gas production reports submitted by the reporting companies) to royalty paid amounts from the payer. If this comparison reveals an underpaid status for the month reviewed, the GLO will submit to the reporting company a Due vs. Paid Invoice for the amount of the underpayment.

REVIEW & RECONCILIATION NOTICES ARE NOT AUDIT BILLING NOTICES

These examinations in no way preclude the GLO from pursuing any claim or remedy related to the royalty payments involved. Additionally, these billings do not constitute an Audit Billing Notice as defined in § 52.135 of the Natural Resources Code and, consequently, per § 52.139(c) of the Natural Resources Code does not preclude the GLO from conducting further examinations of this or other leases operated and/or reported by company or from examining these or other issues and time periods in a future inspection of its books, accounts, reports, or other records.

PENALTY AND INTEREST ASSESSMENT

Additional royalty assessments from the GLO include schedules assessing penalty and interest. Penalty and interest continue to accumulate until the royalty due is paid or resolved. A detailed discussion of penalty and interest assessments are in the “Oil & Gas Reports and Payments Manual”, which can be found at the GLO’s website by following this link:

<http://www.glo.texas.gov/what-we-do/energy-and-minerals/royalty-reporting/RRAC/index.html>

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COMMON OIL AND GAS ROYALTY ISSUES

VALUATION OF OIL AND GAS ROYALTY

The terms of the State lease agreement specify the valuation method for calculation of oil and gas royalty. Common lease terms are quoted below:

OIL

(The lease-defined royalty) "part of the gross production or the market value thereof, at the option of the Lessor, such value to be determined by:

1. the highest posted price, plus premium, if any, offered or paid for oil, condensate, distillate, or other liquid hydrocarbons, respectively, of a like type and gravity in the general area where produced and when run, or
2. the highest market price thereof offered or paid in the general area where produced and when run, or
3. the gross proceeds of the sale thereof, whichever is the greater."

NON-PROCESSED GAS

(The lease-defined royalty) "part of the gross production or the market value thereof, at the option of the Lessor, such value to be based on:

1. the highest market price paid or offered for gas of comparable quality in the general area where produced and when run, or
2. the gross price paid or offered to the producer, whichever is greater."

PROCESSED GAS

(The lease-defined royalty) "part of the residue gas and the liquid hydrocarbons extracted or the market value thereof at the option of the Lessor. All royalties due herein shall be based on one hundred percent (100%) of the total plant production of residue gas attributable to gas produced from this lease, and on fifty percent (50%) or that percent accruing to Lessee, whichever is the greater, The respective royalties on residue gas and on liquid hydrocarbons shall be determined by:

1. the highest market price paid or offered for any gas (or liquid hydrocarbons) of comparable quality in the general area or
2. the gross price paid or offered for such residue gas (or the weighted average gross selling price for the respective grades of liquid hydrocarbons), whichever is the greater."

KEEP WHOLE CLAUSE

The keep whole clause is given as follows:

"In no event, however, shall the royalties payable for processed gas be less than the royalties which would have been due had the gas not been processed."

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COMMON OIL AND GAS ROYALTY ISSUES (CONTINUED)

NON-SALE DISPOSITIONS

LEASE USE FUEL, FLARED GAS & VENTED GAS

As noted in the Valuation of Oil and Gas Royalty section above, both oil and gas royalty is due on gross production as per the terms of the lease. Non-sales dispositions such as lease use, fuel gas, flared gas, and vented gas are also royalty payable in most leases.

Exceptions: Some leases exempt any or all of the above non-sales dispositions.

PLANT FUEL GAS WHEN PROCESSING GAS

Depending on the lease agreement, gas used for plant fuel in the case of processed gas is generally royalty exempt. The following is an excerpt from a lease agreement:

"No royalty shall be payable on any gas as may represent this lease's proportionate share of any fuel used to process gas produced hereunder in any processing plant."

Exceptions: There are some exceptions when a lease agreement would require royalty to be paid for plant fuel gas, and the lessee is required to conform to this agreement.

RECYCLED GAS FOR GAS LIFT OPERATIONS

Gas may be recycled on the lease for gas lift operations, subject to the written consent of the Commissioner of the General Land Office. The lease agreement states as follows:

"No royalties shall be payable on the gas so recycled until such time as the same may thereafter be produced and sold or used by Lessee in such manner as to entitle Lessor to a royalty thereon under the royalty provisions of this lease."

DEDUCTIONS TAKEN PRIOR TO ROYALTY CALCULATION

No deductions are to be taken against gross proceeds before the calculation of royalty due. The following is a common lease term:

"NO DEDUCTIONS: Lessee agrees that all royalties accruing to Lessor under this lease shall be without deduction for the cost of producing, transporting, and otherwise making the oil, gas and other products produced hereunder ready for sale or use."